TESTIMONY OF VERMONT STATE REPRESENTATIVE MARK YOUNG, NATIONAL CONFERENCE OF INSURANCE LEGISLATORS (NCOIL) VICE CHAIR OF THE STATE-FEDERAL RELATIONS COMMITTEE

BEFORE THE U.S. HOUSE OF REPRESENTATIVES FINANCIAL SERVICES COMMITTEE CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES SUBCOMMITTEE

2128 RAYBURN HOUSE OFFICE BUILDING, WASHINGTON, D.C.

JUNE 4, 2002

2:00 P.M.

Chairman Baker, Members of the Subcommittee, thank you for inviting the National Conference of Insurance Legislators (NCOIL) to testify before you today. I am Representative Mark Young. It is my privilege to represent residents of Addison and Rutland counties in the Vermont legislature. It is my further privilege to serve as Vice Chair of the NCOIL State-Federal Relations Committee. NCOIL is an organization of state legislators whose main public policy concern is insurance and insurance regulation. State legislators active in NCOIL chair or are active members of the Insurance Committees in their respective legislative houses across the country.

In response to the Subcommittee's request, my testimony will focus on state guaranty funds and residual markets. In further response to your request, my testimony will report briefly on financial modernization and the progress state legislatures and insurance commissioners are making toward that end.

NCOIL welcomes your request for this testimony on state insurance guaranty funds. The guaranty funds provide an example of how well state insurance regulation can work. In fact, it may be worth noting here that none of the present day critics of state insurance regulation have identified the state guaranty fund system as being inefficient, ineffective or in need of any major reform.

I will first provide some basics on state guaranty funds and their purpose. Then I will move on to discuss how the funds have fulfilled that purpose. I also will provide some observation with regard to needed improvements.

BASICS OF STATE GUARANTY FUNDS

In each state, a guaranty fund consists of the insurers doing business in that state in the line of insurance covered by the fund.

The purpose of state insurance guaranty funds is to make good on the outstanding insurance obligations of insolvent insurers. At the point where the assets of an insolvent insurer are insufficient to meet those claims obligations, the guaranty funds pay the balance up to the limits set by state statutes. The funding of those payments comes from the assessments of the remaining insurers, which range from one to two percent of premium volume, but are pro rata to state market share in the lines of business in which insolvent insurers had engaged.

Each state has its own guaranty fund laws for life and health insurance and for property and casualty insurance. Some states have additional guaranty funds set up for workers' compensation and surplus lines insurance.[1] These state laws conform substantially to model laws adopted by the National Association of Insurance Commissioners (NAIC).

All states post-assess insurers to cover insolvent insurer claims except New York, which pre-assesses its property and casualty guaranty fund up to $200 million.[2] The insurers licensed in

[1] Florida, New Jersey, New York, and Pennsylvania have separate guaranty funds for workers' compensation insurance. New Jersey has a separate guaranty fund for surplus lines insurance.
[2] New Jersey, New York, and Pennsylvania preassess their workers' compensation guaranty funds.

a state constitute the guaranty fund in that state under the supervision of a board of directors and, ultimately, the state's insurance commissioner.

The state guaranty funds coordinate their work, especially with regard to multi-state insolvencies, through two national organizations -- the National Organization of Life and Health Insurance Guaranty Association (NOLHGA) and the National Conference of Insurance Guaranty Funds (NCIGF).

Now for what the funds have done.

The guaranty funds serve as an effective and efficient backstop to safeguard consumer interests in cases of insolvency. The funds have:

-- paid more than $14 billion in the last 25 years to policyholders;

-- grown in financial capacity;

-- done so at no direct cost to state or federal taxpayers;

-- prioritized human needs;

-- assured continuance of coverage to policyholders of insolvent insurers;

-- worked in a comprehensive way to avoid duplication and coordinate activities on a multi-state basis;

-- continued to innovate, testing new ideas and searching for further efficiencies;

-- shown that a competing federal guaranty fund would harm rather than help protection now afforded policyholders; and

-- shown that guaranty funds work and do not need to be fixed in any significant way.

AN EFFECTIVE SAFETY NET

Both the life and health and property-casualty insurance guaranty systems have done what state legislators intended them to do. Life and health insurance guaranty funds report that they have paid more than $5.5 billion in payment of claims and premium refunds since 1988.[3] The property and casualty insurance guaranty funds report that they have paid more than $9.3 billion in claims, premium refunds, and defense costs to over two million insurance consumers over the past 25 years.[4]

The funds have been there when needed. The property-casualty funds system has stood the test of Hurricane Andrew, which felled several insurers, as well as many other insolvencies caused by increases in the costs and severity of medical malpractice claims and expansion of

[3] NOLHGA
[4] NCIGF

toxic and environmental tort liabilities.[5] The guaranty fund system was sufficient when Mission Insurance Group became insolvent in 1985, resulting in $700 million in state guaranty fund payments, the largest amount for a single insurer in history. The system worked during the next four years, when five more national insurers were placed in liquidation, resulting in state guaranty fund payments of an additional $1.9 billion in claims.[6]

GROWTH IN FINANCIAL STRENGTH

State guaranty fund capacity has grown steadily over the years. Over time premium volume has increased, thus increasing the potential revenue from assessments. The capacity of guaranty funds has almost doubled from $2 billion in 1985 to more than $4.8 billion today. According to the NCIGF, even with what could to be the largest multi-state insolvency in the nation's history, that of Reliance, the projected costs to the guaranty funds would be well within the nationwide assessment capacity of the state guaranty fund network. Combined state annual assessments have never exceeded 35 percent of actual capacity.[7]

NO DIRECT TAX IMPACT

State guaranty funds operate and pay claims at no direct cost to the state treasury or taxpayers. The policyholders of all insurers ultimately bear the costs as a part of their premium payments. Sixteen states offset property and casualty insurer assessments through a reduction in premium taxes, while 45 states offset life and health insurer assessments. California, Hawaii, and New Jersey allow insurers to add policy surcharges. The remaining 31 states allow insurers to increase premium rates to cover the assessments.

RESPONSIVENESS TO HARDSHIP CASES

Over the years, guaranty funds have developed ways to deal with hardship cases to protect insurance consumers who are not able to cope with an uninsured loss. Thirty-one states have adopted "net worth" provisions designed to concentrate resources on protecting claimants with the least personal financial resources.[8]

COORDINATION, EFFICIENCIES

The NCIGF and the NOLHGA have helped to coordinate and expedite state efforts in multi-state insolvencies. For example, when a multi-state insurer is declared insolvent, NOLHGA or the NCIGF usually form a task force of guaranty association members representing the impacted states. The task force then develops a coordinated plan for guaranty associations to provide coverage to policyholders on a fair and timely basis.

---

[5] According to the NCIGF, in the past several years, insolvent insurer losses have been impacted by the expansion of toxic and environmental tort liabilities. In addition, the increase in the frequency and cost of medical malpractice claims has bankrupted some insurers, and the soft workers' compensation market has brought other insurers close to peril. The NCIGF says: "The State guaranty fund system has withstood all of these events and has continued to meet its obligations and pay claims without interruption."

[6] Between 1985 and 1989, Transit Casualty Company, Ideal Mutual Insurance Company, Midland Insurance Company, Integrity Insurance Company, Mission Insurance Group and American Mutual Insurance Company all became insolvent.

[7] NCIGF

[8] NCIGF

The NCIGF has served as a point of communication for state liquidators. It has facilitated the negotiation of global settlements of environmental claims between groups of insurers and several state guaranty funds.

Property-casualty guaranty funds have overcome issues related to residency when corporate insureds operated in several states. Such situations have led, in the past, to disputes between the funds and among regulators and to uncertainties among claimants and other insureds. In such cases, the arguments really hinged upon which state guaranty funds should pay what claims. Guaranty funds now a have a system for resolving residency disputes between themselves, before the insured becomes involved.

IMPROVEMENT IN HANDLING INSOLVENCIES

NOLHGA has handled more than 40 insolvencies in recent years. But more importantly, there have been improvements in the speed of administering insolvencies. Ten years ago the handling of a life insurance insolvency took two and one half years. By the late 1990s, such processing sometimes took as little as three months, mainly as a result of reinsurance agreements.

There have also been improvements in the quality of that administration, for example, in the transfer of coverage applicable to a policyholder of an insolvent life insurer to a financially sound life insurer. Life guaranty associations have recognized that the sale of estate assets during a down period in the bond market could result in reduced benefits for policyholders and higher costs to the guaranty associations. In one insolvency, the funds worked with a receiver to organize a new company to assume the bonds of the insolvent insurers' non-insurance subsidiaries. As the value of those assets grows, more money can go to the guaranty association and policyholders, far more than if the receiver had sold them at a fire sale right after a finding of insolvency.

Life guaranty funds also now work with receivers to use so-called liquidating trusts to recover assets. The idea involves setting up a trust that assumes the insolvent insurer’s non-liquid assets, maximizes them, and sells them. It has worked to increase funds available to policyholders in several insolvencies.

RESIDUAL MARKETS AND POOLS

States have also established many different residual market programs to make available insurance to individuals and businesses having difficulty obtaining coverage where the normal market has ceased to function effectively. Residual markets are important for high-risk applicants or individuals and businesses with a poor loss record. Businesses are considered high risk if they have inadequate safety measures in place, the nature of their work is hazardous, the threat of lawsuits is high, or if the location of the business is conducive to theft, vandalism, or severe natural catastrophes.

Residual market insurance premiums are set at a lower level than they would be if they were established on a strictly actuarial basis. Therefore, coverage is attainable for everyone who wants or needs insurance. Profits and losses of each residual market program are shared by all the insurers in a state selling a specific type of insurance. Residual market programs are rarely self-sufficient and generally require assessments to insurers, which are ultimately passed on to all insurance consumers.

The state residual market and pooling mechanism is a proven success and its use continues to grow. For example, over the past several years, property insurers along the East Coast have been withdrawing from coastal states to reduce their exposure to hurricane losses. To compensate for the resulting lack of available coverage, states set up beach and windstorm plans to provide coverage to residents who live in shoreline communities. Between 1992 and 1999, the residual plans' exposure grew from $17 billion to $112 billion.

Another example is the automobile residual market. 41 states and the District of Columbia currently use automobile insurance assigned risk plans to guarantee that auto insurance is available to those who need it. Under the programs, when an applicant is unable to secure auto insurance, the state coordinating office randomly distributes applications to all insurance companies that offer auto liability coverage in the state, in proportion to the amount of their normal business. The insurers must provide coverage to these individuals and assume the losses. However, they are able to restrict the coverage limits and charge significantly higher premiums. Together, the nation's auto residual market programs insured about 3.4 million cars in 1998, or 2.1 percent of the total market.

Some other examples of residual market and pooling mechanisms within the states include: Joint Underwriting Associations (JUA's), Market Assistance Plans (MAP's), Fair Access to Insurance Requirements (FAIR), Rural Risk Plans, Workers' Compensation Assigned Risk Plans and Second Injury Funds, and Unsatisfied Judgement Funds.

THE HARMFULNESS OF A COMPETING FEDERAL SAFETY NET

Against this backdrop, the idea of a separate and competing federal guaranty system of insurers operating under a federal charter, such as those proposed in Congress by Sen. Schumer (NY) and Rep. La Falce (NY), could not help but weaken the state-based system. It would weaken the strong state consumer safety net, deplete its capacity from $4.8 billion to less than $3.0 billion[9], and reduce its overall risk pools. It would build another layer of overhead, create duplication in process and add unnecessary expense.

We believe the system has worked well. It is in no way broken. Congress, I respectfully submit, does not need to fix it, replace it, or establish anything parallel to it.

ISSUES BEFORE THE FUNDS

None of this is to say that the present guaranty fund system is perfect. Questions can still arise as to which guaranty law might apply to losses involving residents of different states. The NAIC has developed and recommended the establishment of priority rules based upon the respective residences of the insured, the claimant, and the property insured. NCIGF has implemented a mediation process for guaranty funds for use in cases where there is uncertainty of state responsibility among funds.

Assessments have, at times, presented problems. The up to one to two percent difference among states in assessment limitations has caused some problems. But, when faced with such

[9] ggggg

issues, individual state guaranty funds have been able to raise additional needed funds. In the aftermath of Hurricane Andrew, Florida's guaranty fund lacked sufficient assessment capacity in a single year. Florida overcame the deficit through a bond issue. It paid back the principal and interest in later years through assessments.

Another issue arises from the lack of uniformity of coverage limits and the types of coverage offered under different state guaranty fund laws. The range in maximum payment limits ranges from $50,000 per claim to as high as $1,000,000, though most states have limits ranging from $100,000 to $300,000 per claim. Most states, however, do not apply any cap to workers' compensation claims. In a 1992 report, the General Accounting Office (GAO) noted that persons residing in different states could receive less or more in payments for the same claim depending on the different state limits.

Such differences, I submit, exist for good reason. Property prices, state tort laws and property market values vary widely among states. Uniformity could lead to uneven treatment.

Since 1992, when NCOIL endorsed the NAIC models acts I have referenced above, NCOIL saw the need for an interstate compact which would govern, among other things, multi-state insolvencies. NCOIL's adoption followed public hearings in Indianapolis in 1991, San Antonio in 1992 and New York City in 1994. The proposed compact evolved into what is today the Interstate Receivership Compact (IRC). That compact was developed by Commissioners in the NAIC Midwest Zone and NCOIL legislators. That compact remains untested, due mainly to the fact there have been no receiverships for it to process and because of the low number of participating states. NCOIL is working with other states to increase the membership of the IRC.

While guaranty funds stand well today, we believe continued oversight is absolutely essential to the continuance of their effective function. We submit that an interstate compact idea is one that is available if needed. Simple expansion of the receivership compact would be one way to approach it.

But for now the guaranty fund system does not require the focus of Congress, although your constructive oversight is welcomed and appreciated.

FINANCIAL MODERNIZATION

Worthy of all our attention is regulatory modernization. It is proceeding. I will focus the balance of my testimony on that subject. To a great extent what follows will update the testimony before this subcommittee of former NCOIL President, State Representative Terry Parke of Illinois, on June 21, 2001.

Technological changes and globalization of insurance markets have challenged the states to modernize the regulation of the business of insurance. Essential states need to do three things. States need to establish (1) a one-stop, reciprocal and uniform system of licensing; (2) a fast, centralized system for policy form and rate approvals; and (3) a fundamentally reformed system of market conduct regulation.

States are well on their way to achieving each of these goals.

States are enacting laws that provide for reciprocity in agent and broker licensing. The states beat the NARAB deadline established by GLBA by more than 18 months.

States are beginning to consider proposals for the national chartering of insurance companies within a state based regulatory system. NCOIL will consider such a proposal for one-stop shopping for insurance company licenses at its upcoming meeting in Boston in July.

NCOIL continues to believe that company licensing is an area that lends itself to the use of an interstate compact. New York State Senator Neil Breslin made that point in testimony before the House Commerce Committee at a hearing chaired by Representative Oxley on July 20, 2000.

The NAIC has developed a draft of an interstate compact that would allow for a single point of filing for life insurance and annuity contracts. NCOIL is presently reviewing that draft in the expectation of giving its input and support to the NAIC in this important enterprise. NCOIL has a long established record of support for interstate compacts in insurance regulation. The present NAIC draft borrows on the procedures provisions of the NAIC Midwest Zone - NCOIL Interstate Receivership Compact referenced earlier in this testimony.

More than 20 states have achieved speed in rate and form approval with the adoption of the NCOIL Commercial Lines Deregulation Model Act. Since the June 2001 hearing, NCOIL has adopted a model Property/Casualty Insurance Modernization Act. It would remove premium rate approval requirements in both commercial and personal lines.

States, through a comprehensive market conduct study in 1999, identified areas where there is need of market conduct regulation reform. That study found duplication of effort and lack of coordination and training in market conduct regulation. It also discovered widespread disagreement with respect to the purpose of market conduct regulation.

NCOIL has decided to conduct a second and final study of market conduct regulation. That study will make findings relative to the goals of market conduct examination and the specific means for achieving those goals. It is our goal to bring market conduct examination of insurers to the same level of efficiency, coordination and effect now associated with examinations of insurer financial strength.

I thank you again for the opportunity to provide this testimony and I would be happy to answer your questions.

M:/NCOIL/2002 Documents/2003400e.doc